Supreme Court, U.S.
FILED
AUG 16 2004
OFFICE OF THE CLERK

Nos. 03-892 and 03-907

IN THE

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writs of Certiorari to the United States Courts of Appeals for the Sixth and Ninth Circuits

BRIEF OF KENNETH W. GIDEON, MAXINE AARONSON, GAIL RICHMOND, AND MONA L. HYMEL AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*

Kenneth W. Gideon, Maxine Aaronson, Gail Richmond, and Mona L. Hymel are tax attorneys who have advised clients, made continuing legal education and bar presentations, or written on the tax treatment of contingent attorney's fees over many years. Gail Richmond and Mona L. Hymel are tax professors.[1]

SUMMARY OF ARGUMENT

Under the position espoused by the United States in the two cases before the Court, a recovery of nominal damages (say $1) together with an award of substantial attorney's fees (say $275,000) by an unmarried plaintiff who successfully vindicates an important right justifying the award of such fees will result in that plaintiff receiving a tax bill from the Internal Revenue Service for not less than $73,500, despite the fact that the only amount received by the plaintiff was a single dollar.[2] The plaintiff's attorneys

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief have been filed with the Clerk. Pursuant to this Court's Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party. No person other than the *amici* has made a monetary contribution to the preparation or submission of this brief.

[2] Although attorney's fees are deductible for regular income tax purposes under either 26 U.S.C. § 162 (ordinary and necessary business expenses) or § 212 (expenses for the production of income), neither employee business expenses nor § 212 deductions are allowed for purposes of the alternative minimum tax imposed by 26 U.S.C. § 55. On the facts stated above, if fees received by the plaintiff's attorney are also included in the plaintiff's income (as the Government contends), the tax imposed would be at least $73,500 ($275,001 gross income x 26% tax rate on the first $175,000 and 28% on any additional amount per § 55(b)(1)(A)(i)(I)). If attorney's fees of the magnitude set forth in the example are included in the plaintiff's income, any exemption provided by § 55(d)(1)(B) would be fully phased out. 26 U.S.C. § 55(d)(3)(B).

will receive (and also be taxed) on the $275,000 in awarded fees. Imposing a tax bill of $73,500 on a single dollar of disposable income cannot be defended on policy grounds, nor can it plausibly be contended that so anomalous a result was "intended" by Congress.

The possibility that a successful plaintiff would owe the Government more in taxes than the plaintiff recovers is not a mere hypothetical possibility under the Government's position.[3] The actual facts of the *Banaitis* case illustrate the anomaly of the Government's position as well. Although the maximum individual income tax rate enacted by Congress in 26 U.S.C. § 1 is currently 35 percent, the effective rates of tax on the amounts actually paid to Mr. Banaitis and Mr. Banks are well in excess of the 35 percent rate. *Banaitis v. Commissioner*, 340 F.3d 1074, 1078 (9th Cir. 2003); *Banks v. Commissioner*, 345 F.3d 373, 376-77 (6th Cir. 2003).

This result, the Government argues, is compelled by the Internal Revenue Code and the assignment of income doctrine set forth in this Court's decisions in *Lucas v. Earl*, 281 U.S. 111 (1930) ("*Earl*") and *Helvering v. Horst*, 311 U.S. 112 (1940) ("*Horst*"). Neither case requires the result the Government seeks. No Code provision demonstrates any intention by Congress to tax litigants as the Government contends.

The assignment of income doctrine is an anti-abuse rule devised by this Court to prevent inappropriate income shifting among family members or other related persons. In

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[3] *See* Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. Times, Aug. 11, 2002, at A12, reporting the case of a Chicago police officer who recovered an award for sex discrimination and harassment of $300,000 and attorney's fees of more than $1,000,000 with the result that her tax bill consumed her entire $300,000 award and left her owing the Internal Revenue Service more than $99,000 in taxes.

contrast to *Earl* and *Horst*, there is no taxpayer "abuse" in the cases at bar. They involve the most common form of funding of individual tort litigation – contingent fees – not an artificial shifting of income designed to defeat the income tax laws.[4] These cases represent an effort by the Government to impose an irrationally high and highly variable level of tax burden on successful plaintiffs. The exact rate depends on the fees payable to a plaintiff's attorney rather than the amount received by or under the dominion and control of the taxpayer. There is no Congressional mandate to tax the same income to plaintiffs as well as to their attorneys.

The assignment of income doctrine emerging from *Earl* and *Horst* is the judiciary's creation, not an enactment of Congress. It is not a constitutional principle or immutable "super law." In the court decisions that have adopted the Government's position that the assignment of income doctrine should be extended to reach contingent fees, the authors of the decisions have described the result as one that "smacks of injustice," is "unfortunate" and has a "potential for unfairness." *See, e.g.*, *Alexander v. IRS*, 72 F.3d 938, 946 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107, 115 (2d Cir. 2004); *Kenseth v. Commissioner*, 114 T.C. 399, 407 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001). It is the duty of this Court, as the author of the assignment of income doctrine, to correct that doctrine's erroneous application to these circumstances.

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[4] The plaintiffs and the attorneys in the two cases before the Court are not related. Nor is there any suggestion that the contingent fees paid in either case are anything other than arm's length transactions. In contrast, both *Earl* and *Horst* involved intrafamily gifts.

ARGUMENT

I. THE INTERNAL REVENUE CODE CONTAINS NO PROVISION REQUIRING THAT A CONTINGENT FEE PAID TO THE ATTORNEY FOR A SUCCESSFUL PLAINTIFF BE TAXABLE TO BOTH THE PLAINTIFF AND THE ATTORNEY

The question in this case depends upon whether a plaintiff is taxable on an amount paid to the plaintiff's attorney under either a contingent fee contract (providing that a percentage of any recovery will be payable to the plaintiff's attorney) or under a statutory provision authorizing recovery of attorney's fees as well as damages.[5] In its brief, the Government identifies no provision of the Code that requires that such fees be taxed as if they were first income to the plaintiff and then taxed again to the attorney, and there is none.[6]

Instead, the Government relies on cases such as *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (holding that antitrust treble damages were taxable) and

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[5] *See, e.g.*, 42 U.S.C. § 2000e-5(k) (providing for attorney's fees under the Civil Rights Act of 1964).

[6] Congress has limited the deductibility of attorney's fees incurred as employee business expenses (*i.e.*, fees incurred without granting the attorney any share in any ultimate recovery) for purposes of the regular tax, 26 U.S.C. §§ 62(a)(2) and 67, and denied the deduction altogether for purposes of the alternative minimum tax, 26 U.S.C. §§ 55-56. Those situations differ from the contingent fee arrangements in which the plaintiff cannot exercise dominion and control over the amount received by the attorney. The statutory language imposing deduction limitations on employee business expenses discloses no Congressional intention to tax plaintiffs on fees paid to their attorneys under contingent fee arrangements.

Commissioner v. Schleier, 515 U.S. 323 (1995) (holding that age discrimination recoveries were not compensation for personal injuries) for the proposition that 26 U.S.C. § 61(a) exercises "the full measure of [Congress'] taxing power" and taxes "all gains except those specifically exempted." (Petitioner's Brief at 15.)

The question is not whether the attorney's fee is gross income; the question is whose gross income is it? Attorney's fees (from the perspective of a plaintiff as opposed to an attorney) do not meet the *Glenshaw Glass* standard of "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." 348 U.S. at 431. Regardless of the vagaries of state attorney's lien laws,[7] all such laws provide that once a properly executed contingent fee contract is in place (and the attorney performs the services required under the contract), the attorney, not the litigant, enjoys the wealth embodied in the fee, realizes that amount, and has complete dominion over it. As this Court observed long after the decisions in *Earl* and *Horst*,

> We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving . . . . The underlying assumption always has been

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[7] While the Government errs in attempting to attribute fees earned by and belonging to the attorney in a contingent fee case to the plaintiff, it is correct that the consequences of such contingency fee arrangements should not depend on subtle variations in state lien law. Under all the states' attorney lien laws, the plaintiff cannot exercise dominion or control over the portion of any recovery payable to the plaintiff's attorney under a contingent fee contract absent the attorney's malfeasance or failure to perform. It is this core reality that should govern the Federal tax consequences of contingent fee and statutory attorney's fee cases, not the variations in each state's law.

> that in order to be taxed for income, a taxpayer must have complete dominion over it.

Commissioner v. First Sec. Bank, 405 U.S. 394, 403 (1972).[8]

II. THE ASSIGNMENT OF INCOME DOCTRINE DOES NOT REQUIRE THAT A PLAINTIFF BE TAXED ON INCOME HE DID NOT EARN AND CAN NEVER RECEIVE OR CONTROL

Earl dealt with an individual's effort to assign one-half of his salary to his wife for reasons unrelated to the income tax. (Indeed, the assignment in 1901 was made long before the income tax was enacted.) As the *Earl* Court noted, performance of the services giving rise to the taxpayer's salary could not "be taken by anyone but himself alone." 281 U.S. at 114. By contrast, litigants engage attorneys precisely because they themselves lack the ability to successfully pursue their claim without the assistance of a person trained in the law and skilled in legal matters. As the Sixth Circuit recognized in *Banks*, 345 F.3d at 384, the

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[8] The Government cites *Helvering v. Clifford*, 309 U.S. 331, 338 (1940), but that case did not reach the assignment of income doctrine. The Court found the settlor's dominion over the income and corpus in a family trust situation was so little disturbed by the purported assignment to other family members that it was ineffective for income tax purposes. In *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729-31 (1929), also cited by the Government, this Court held that an employer's payment of the income tax on an employee's salary constituted additional taxable income to the employee. Unlike this case, there was no issue there as to whether the income on which the tax payment was predicated was properly taxable to the employee; it was the employee's salary which could not be attributed to the efforts of any other person. *Old Colony Trust* thus does not reach the question of whether contingent fees or statutory attorney's fees are includible in a plaintiff's income and does not provide a precedent for such inclusion.

taxpayers were "dependent upon the attorney's skills to realize any value from [their claims]." *Horst* involved a gift of bond coupons for periodic interest payments by a father to a son while the father retained the bond itself (and the right to principal repayment the bond itself represented).[9] *Horst* recognized that its conclusion (that the interest income remained taxable to the father) was dependent upon the conclusion that the father was the person "who earn[ed] or otherwise create[d] the right to receive it and enjoy the benefit of it when paid." 311 U.S. at 119.

Had either of the taxpayers in *Earl* or *Horst* succeeded in transferring the tax on income earned by the donor to relatives in lower tax brackets, the progressive income tax rate structure as enacted by Congress would have been circumvented. As in another of this Court's landmark anti-abuse decisions of the same era, *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), the assignments attempted in *Earl* and *Horst* did not comport with Congressional intent. Consistency with the reasoning of *Gregory*, however, requires that the Government likewise be forbidden to achieve unintended and unjust results based on essentially technical arguments.

While it is undoubtedly true that "income is taxed to the person who earned it" (Petitioner's Brief at 14), the Government errs in asserting that Mr. Banks and Mr.

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[9] Both *Earl* and *Horst* have been displaced on their specific facts by subsequent statutory provisions crafted by Congress to address the issues in those cases. Thus, Congress has provided a different rate schedule for married taxpayers filing joint returns in 26 U.S.C. § 1(a) to address (at least to some degree) the difference in taxation between taxation of income earned by married taxpayers in separate property and community property states. The income taxation of stripped bond coupons at issue in *Horst* is now governed by 26 U.S.C. § 1286 and would now differ substantially from the result reached in *Horst*.

Banaitis "would have been required to include the entire taxable proceeds from those courses of action in their gross income if the proceeds had been paid directly to them." (Petitioner's Brief at 16; *see also id.* at 24.) Tax consequences do not turn on the formalities of how funds are transferred, but on the economic rights of the parties in those funds and the substance of the transactions. For example, under 26 U.S.C. § 482 and the regulations thereunder dealing with related party transactions, taxable income is allocable to the taxpayer who bears the risks, exercises functional control, and has the contractual responsibility and duty to perform services, not the one who received a payment in the first instance. Treas. Reg. § 1.482-1(d)(1).

Prior to the filing of any lawsuit, the plaintiffs here, by executing contingent fee contracts, separated themselves from any dominion or control over the amounts that would ultimately become payable to their attorneys in the event of a recovery. At the time those contracts were entered into, there was no certainty that the plaintiffs would recover any amount, and the amounts recovered were clearly dependent upon the skill and efforts of their attorneys.[10] Unlike the

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[10] In Private Letter Ruling 200427009 (July 2, 2004), the Internal Revenue Service held that a plaintiff's partial allocation of a claim against an insurer to a third party (in consideration for the third party's forgoing certain claims against the plaintiff) did not constitute an assignment of income. In the ruling, the Internal Revenue Service stated that "in general, a transferor who makes an effective transfer of a claim in litigation to a third person prior to the time of the expiration of appeals in the case is not required to include the proceeds of the judgment in income under the assignment of income doctrine because such claims are contingent and doubtful in nature." The ruling held specifically that the assignment of income doctrine did not apply. By application of similar analysis in this case, an allocation of a portion of a claim to an attorney as a contingent fee would result in the fee being gross income only to the attorney. No portion would be income to the plaintiff. Under 26 U.S.C. § 6110(k)(3), such rulings may not be relied on as precedent; however, this Court has cited such rulings where the analysis in the ruling was

salary in *Earl* or the bond coupon in *Horst*, there was no certainty that any amount could be collected. The active involvement and effort of plaintiffs' attorneys were required to bring the recoveries about. The plaintiffs here could not generate their recoveries by their efforts or capital alone.

Referring to a contingency fee arrangement, the Sixth Circuit in *Estate of Clarks v. United States*, 202 F.3d 854, 857-58 (6th Cir. 2000) stated, "[t]he present transaction . . . is more like a division of property than an assignment of income" because "the value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel." The Sixth Circuit recognized this fact in *Banks*, stating that "a contingency fee, as part of a litigation claim, was not already earned, vested, or even relatively certain to be paid to the assignor, but instead was merely 'an intangible, contingent expectancy,' dependent upon the attorney's skills to realize any value from it." 345 F.3d at 384 (citation omitted).

In support of its argument that attorney's fees under a contingent fee contract or statutory award are taxable to both the plaintiff and the attorney who earned them, the Government, citing the Seventh Circuit's decision in *Kenseth v. Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001), contends that failure to attribute the amount payable as a contingent attorney's fee to the plaintiff would unfairly distinguish contingent fees from attorney's fees determined on an hourly basis. (Petitioner's Brief at 24; *see also id.* at 31.) But the hourly-fee-paying plaintiff gives up nothing with respect to any part of any judgment or settlement ultimately received. Such a plaintiff may dismiss one

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pertinent to the issue before the Court. *See, e.g., Rowan Cos. v. United States*, 452 U.S. 247, 261 n.17 (1981); *Hanover Bank v. Commissioner*, 369 U.S. 672, 686-87 (1962).

attorney at will and hire another because the attorney has no right of any kind in the recovery and does not share the risk of loss or the reward of success. Indeed, at some later point in the litigation, such a plaintiff may choose to enter into a contingent fee contract if the payment of hourly fees proves too onerous. In contrast, a plaintiff who has entered into a contingent fee arrangement cannot divest a performing attorney of the attorney's right to a specified portion of the ultimate award and has restricted abilities to terminate the attorney.

The argument that parity between contingent fee payors and hourly fee payors is desirable as a "neutral principle" cannot justify the draconian results of the Government's position. Indeed, the Government's position will prevent some plaintiffs from vindicating important legal rights for fear that any monetary award will be insufficient to cover the tax assessed on the plaintiff for the contingent fee paid to the attorney.[11]

Admittedly, the client in a contingent fee arrangement typically retains two rights: the right to dismiss the lawsuit (and thus preclude any recovery) and the right to approve any settlement (*i.e.*, the attorney cannot settle the plaintiff's lawsuit without the plaintiff's consent). But neither of these rights differs from the rights a co-venturer or co-owner may exercise without being treated as "earning" the share of income accruing to the other venturer or owner.

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[11] *See, e.g., City of Riverside v. Rivera*, 477 U.S. 561, 577-78 (1986) (recognizing that "'[F]ee awards have proved an essential remedy if private citizens are to have a meaningful opportunity to vindicate the important Congressional policies which these laws contain.'" (citation omitted)); *Deposit Guar. Nat'l Bank v. Roper*, 445 U.S. 326, 338 (1980) (recognizing the important role contingent fee arrangements have "played in vindicating the rights of individuals who otherwise might not consider it worth the candle to embark on litigation . . . .").

These legal relationships have long been recognized by the Government as being outside the assignment of income doctrine.[12]

As *Earl* and *Horst* demonstrate, this Court adopted the assignment of income doctrine in the intrafamily context and has applied it in the context of assignments and transfers between related parties. *See, e.g., Commissioner v. Culbertson*, 337 U.S. 733 (1949) (applying doctrine in the context of intrafamily assignment); *United States v. Basye*, 410 U.S. 441 (1973) (applying doctrine in the context of assignments among a partnership and its partners); *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983) (applying doctrine in the context of assignments between a corporation and its shareholders). The extension of such a judge-made doctrine beyond the related party context in which it developed is simply not warranted in these cases and the result of such extension "smacks of injustice."[13]

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[12] It is well settled that co-owners are taxable only on their proportionate shares of the income received. *See Pearsall v. United States*, 52 F.2d 1050 (Ct. Cl. 1931) (undivided interest in exclusive sales agency for specialized iron products); *Ferry Market, Inc. v. Commissioner*, 5 B.T.A. 167 (1926) (fractional interest in steam schooner). In real estate ventures and crop share farming, all parties benefit from shared efforts in the same sense that a plaintiff benefits from an attorney's efforts, yet those co-venturers report only their own income share. They are not taxed on another party's income and then forced to deduct the third party's share as an expense for the production of income. *See Bartholomew v. Commissioner*, 10 T.C.M. (CCH) 957 (1951) (engineer who contributed services was joint venturer with investors in real estate project); *Podell v. Commissioner*, 55 T.C. 429 (1970) (attorney providing capital is joint venturer with real estate operator providing services).

[13] The Tax Court majority in *Kenseth* premised its adoption of the Government's position here on its perception of "dangers in the ad hoc modification of established tax law principles or doctrines [*i.e.*, the assignment of income doctrine] to counteract hardship in specific cases."

CONCLUSION

The Tax Court dissenters in *Kenseth v. Commissioner* had it right when they protested that:

> The [Tax Court] majority in the instant case tax to petitioners substantial funds that petitioners did not receive, were never entitled to receive, and never turned their backs on. They do so in the name of the assignment of income doctrine. The majority acknowledge that there may be injustice in so doing, and that the injustice may well be even greater in other real-life settings than in the instant case. They contend that precedents compel them to this result and that relief can come only from the hills (Psalm 121), or at least from Capitol Hill. But this Court has shown . . . that reexamination of the origins of the assignment of income doctrine can sharpen our understanding of the concepts and make more rational the application of that doctrine. We do not lightly overrule our prior decisions. But when experience and analysis show that we have departed from the origins that we once thought to be the foundations of

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Kenseth, 114 T.C. at 407. However, neither the Government in its brief nor any of the courts that have adopted the Government's position have articulated what those "dangers" might be. Indeed, respecting unrelated parties' allocation of income in a contingent fee context just as they are respected in partnerships, sharecropping situations and other co-venturer arrangements poses no such "danger." Thus, ruling that the assignment of income doctrine does not apply here is not an "ad hoc modification of established tax law principles," but rather an opportunity for this Court to prevent an unjust and erroneous expansion of the assignment of income doctrine and to clarify that the doctrine is not applicable in the contingent fee context where there are no related parties.

> those decisions, and when it is our judicial interpretations and not the statute law that lead to results that increasingly seem to be unjust, then we ought to reexamine the foundations of the doctrine.

114 T.C. at 420-21 (citations omitted).

This Court should not permit the assignment of income doctrine, a judicially crafted anti-abuse rule, to become itself a source of abuse and injustice. Indeed, a refocusing on the basis for the assignment of income doctrine would be completely consistent with Justice Holmes' admonition in *Earl* that the decision should turn "on the import and reasonable construction of the taxing act," 281 U.S. at 114, and with Justice Stone's pronouncement in *Horst* that "[c]ommon understanding and experience are the touchstones for the interpretation of the revenue laws," 311 U.S. at 118. Taxing plaintiffs on income they can never receive or control and which their attorneys, not they, have earned, defies both "common understanding and experience" and is not a "reasonable construction" of the Internal Revenue Code.

This Court should affirm both judgments and hold that the taxpayers are not taxable on contingent fees that

were paid to their attorneys and over which they had no dominion or control.

Respectfully submitted,

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AUGUST 2004